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STATE FOR EUR/RUS, EEB/IFD
TREASURY FOR TORGERSON
DOC FOR 4231/MAC/EUR/JBROUGHER
NSC FOR MCFAUL

E.O. 12958: DECL: 05/08/2019
TAGS: EFIN ECON RS
SUBJECT: RUSSIAN BANKING SECTOR'S SECOND CRISIS

Classified By: Acting DCM Eric T. Schultz, Reasons 1.4 (b/d).

¶1. (C) Summary. Russia's banking sector is preparing for a second wave of the financial crisis. Banks have been setting aside a higher-than-required share of in-house resources as provisions against an anticipated rise in non-peforming loans (NPLs). Some observers, including Sberbank President German Gref, nonetheless expect a dangerous level of NPLs before the end of the year. The GOR is still considering the options and conditions in which it would provide assistance to banks carrying "bad loans." However, some banks have already embarked on restructuring negotiations with their borrowers, and as the economic outlook continues to deteriorate, an increasing number of banks will struggle to manage the stress that more NPLs will impose on their operations. In light of limited reserves and other spending commitments, the GOR will probably not be able to respond with a system-wide program to support troubled banks, focusing instead on "systemic" banks and allowing others to consolidate and even fail. Much will depend on whether the government is able to manage this process in an orderly fashion. End Summary.

Banking Sector Prepares for Second Wave

¶2. (C) Many banks have begun to impose stringent requirements on borrowers, including for their long-term and trusted clients who experienced severe losses at the outset of the financial crisis. As VTB Investor Relations Director Neil Withers recently told us, many banks "no longer accept just a phone call from an oligarch as a substitute for collateral." Borrowers, whether oligarchs or sole proprietors of small businesses, must now pledge bona fide assets that are in keeping with the size of the loans they need. For new borrowers, which many banks have deemed synonymous with "risky," the more daunting rules on collateral are coupled with prohibitive rates of 20 percent or more.

¶3. (C) In addition to elevated standards for collateral, the sector as a whole has voluntarily raised its capital adequacy ratio, a measure of a bank's long-term capital relative to all loans earmarked as a provision against the possibility of non-performing loans (NPLs). The Central Bank (CBR) has been loosely enforcing the Basel-II capital adequacy standards, but the banking sector overall currently boasts a ratio of nearly 17 percent.

¶4. (C) According to MDM Bank Chief Economist Nikolay Kashcheev, the higher-than-required ratio strongly suggests banks anticipate problems with their loan portfolios. Kashcheev told us the current ratio also partially explains

officials' frustration that banks have not supplied enough credit to the economy. Rather than use 100 percent of the government-supplied financing to provide credit to businesses, banks have used a significant share of those funds as a means of protecting themselves against possible defaults.

¶5. (C) Some banks have also reportedly begun their own bad debt restructuring programs. Trust Bank Chief Economist Evgeniy Nadorshin told us Trust's "Banking Sector Navigator" uncovered a slowdown in the growth of banks' corporate NPLs, from a growth rate of more than 23 percent in January, to 22 percent in February, to 11 percent in March. Nadorshin said the March figure did not reflect an improvement in economic conditions but rather a concerted effort to restructure problem loans. He speculated one reason for the restructuring was banks' interest in presenting the best possible indicators so they would continue to qualify for the CBR's un-collateralized lending facility.

¶6. (C) The steps that banks have taken to mitigate the effects of potential loan defaults supports officials' and bankers' public expressions of concern about rising NPLs later in the year. Sberbank President Gref recently echoed Finance Minister Kudrin's concern that NPLs, and the fear of NPLs, could hinder the GOR's anti-crisis plans. Gref said NPLs could exceed 10 percent for his bank alone. Others, including Alfa Bank's respected Chief Economist Natalya Orlova, believe the rate may be as much as 15-20 percent system-wide, reaching 30 percent or more in some banks. Citibank Chief Economist Elina Ribakova told us that NPLs of 10 percent was part of her best-case scenario for the end of the year.

¶7. (C) The implication of a dangerous level of NPLs has cast doubts on the GOR's plan to support the banking sector through systemic recapitalization. If NPL-related strains were to emerge across the sector, the GOR would be compelled to shift away from recapitalization and toward either rescuing banks or organizing a "bad debt" restructuring program.

Inadequate GOR Response

¶8. (C) For its part, the GOR has not yet modified its anti-crisis response program to include a plan for the banking sector's potential NPL problem. Officials acknowledge the pressures of the ongoing slowdown for the country in general and the banking sector in particular but, to date, have not devised a concrete proposal on how the GOR might support the sector as the crisis worsens. For the time being, the message from the highest levels has generally been to stay the course, with the modification that the GOR will impose more rigorous conditions on the use of government-supplied long-term financing. Prime Minister Putin, for instance, told attendees at a recent government meeting on economic policy that banks receiving long-term financing from Vneshekonombank (VEB) must use 100 percent of that funding to make loans and must not charge more than 3 percentage points above the CBR's refinancing rate. Ribakova said that adherence to this policy was likely to be counterproductive. The GOR continued to push for the expansion of credit while at the same time using heavy-handed supervision in terms of which areas of the economy should receive priority consideration for loans.

¶9. (C) First Deputy CBR Chairman Aleksey Ulyukaev, moreover, publicly disputed concerns that Kudrin, Gref and Deposit Insurance Agency Director Turbanov have raised about the likely severity of the NPL threat. Ulyukaev maintained that neither the current level of, nor the rate of growth in, NPLs presented a cause for concern. He argued in a recent interview with Vedomosti that there would be no "second wave" of the crisis because there was no "first wave." As the crisis intensified last fall, the GOR succeeded in supporting banks by supplying sufficient liquidity to the sector overall

and by facilitating the rescue of individual banks in distress. According to Ulyukaev, economic policymakers prevented a panic and would be able to repeat last fall's achievement if necessary. (Note: Ulyukaev's interpretation that the events of last fall did not constitute a "first wave" of the financial crisis for the banking sector is a stylized reading of the facts. The first round of the crisis came at a time when surplus budget funds and substantially higher reserves gave policymakers flexibility in their options. Simply because the GOR was able to avert a panic does not mean the first wave did not exist. End Note.)

¶10. (C) In a rare breaking of ranks, Finance Minister Kudrin publicly disagreed with other officials concerning the scope of the NPL problem. His comments have emphasized that the rate of growth in NPLs could destabilize the sector, prompting the collapse of many banks and, thereby, rupturing confidence in the financial system. Policymakers, therefore, needed to consider alternatives to the bank re-capitalization aspect of the GOR's anti-crisis plan. However, disagreement among officials on this point has meant the absence of a contingency option to address the effects of a hazardous level of NPLs.

¶11. (C) New Economic School Rector Sergei Guriev confirmed for us that the GOR's internal disagreements, between the CBR and First Deputy Prime Minister Shuvalov on one hand and Kudrin and the Finance Ministry on the other, was hampering the GOR's policy response. Guriev said Kudrin's more pessimistic view was right and expressed hope that the "stress tests" the CBR had begun conducting on Russian banks (with IMF help) would lead to a more proactive GOR approach.

Scenarios and Consequences

¶12. (C) European Bank for Reconstruction and Development (EBRD) Economist Alexandre Plekhanov told us he expects one of three scenarios for the banking sector to begin to take shape by the end of the year. First, Russia could imitate the method by which China addressed its high NPL problem of recent years. That is, a further devaluation of the ruble could allow Russia more flexibility to export its way out of the problem and harness the potential of an import-substition response. The strains on the banking sector would work themselves out in the process. Second, the GOR could set guidelines for a domestic debt restructuring process, if not an institution that would serve as a mechanism for clearing the bad loans from banks' balance sheets. Third, banks could "hide" their NPLs through a series of false restructuring agreements.

¶13. (C) JP Morgan Chief Economist Peter Westin told us that if the GOR's recapitalization efforts were to founder as a result of growing stress on banks' balance sheets the GOR would probably focus its attention on the 50 largest banks, since they claimed the overwhelming majority of existing deposits. Westin speculated the Deposit Insurance Agency (DIA) might receive additional funding to facilitate the takeover/acquisition of distressed banks by interested investors. However, the DIA faced substantial personnel constraints and would not be able to rehabilitate or rescue more than 5 to 6 banks at any one time.

¶14. (C) Guriev told us that there would almost certainly be bank failures given the GOR's dwindling resources. The GOR had set aside $40 billion from the National Welfare Fund, the remainder of the funds it had originally earmarked last fall to support Russian equities, to recapitalize banks. However, Guriev said it would not be enough. A more realistic figure was $85 billion to recapitalize the sector, even if oil prices stayed above $50 per barrel. His biggest concern, he said, was that the GOR would wait too long or otherwise mishandle the bank failures, further undermining the economy.

Comment

¶15. (C) The GOR will likely have neither the resources nor the strategy for assisting with banks' bad debts. A budget deficit of 8 percent this year and dwindling reserves give policy makers little flexibility in responding to banks' needs. Support for banks will probably be directed at systemic banks and will be ad hoc, selective and less than transparent. The second wave intimated by a steady climb of NPLs threatens to find the GOR poorly prepared, with the CBR and other parts of the government in denial about the depth of the problem. Without the resources to repeat last year's success in preventing a panic, the GOR will likely need to get its act together soon if it is to manage this second wave in an orderly fashion. End Comment.
RUBIN